An end to rules on racial, gender and LGTBQ+ diversity on Nasdaq-listed company boards

In *Alliance for Fair Board Recruitment; NCPPR v. SEC,* the U.S. Court of Appeals (Fifth Circuit) vacates, by a one-vote margin, the Securities & Exchange Commission's approval in 2021 of Nasdaq's rules on board diversity for companies listed on its exchange.

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In a tight split 9-8 decision, the United States Court of Appeals for the Fifth Circuit has vacated the order of the Securities & Exchange Commission (SEC) approving in 2021 Nasdaq's 'Board Diversity Proposal' *(Alliance for Fair Board Recruitment; National Center for Public Policy Research v. SEC*, 11 December 2024).

Companies listed on Nasdaq have traditionally had a rather homogenous board composition, with a low presence of female directors. On 6 August 2021, the SEC approved the amendment of Nasdaq's rules, so that, in general terms, listed companies would have to disclose information about the racial, gender, and sexual characteristics of their directors and have at least two directors who met Nasdaq's definition of diverse - one self-identifying as a female and a second self-identifying as an underrepresented minority, whether LGTBQ+ or racial - or explain why they did not (the 'comply or explain' principle). The foregoing included exceptions for foreign issuers, investment managers and special purpose entities, among others.

In its decision, the Court of Appeals reviews the history of the Securities Exchange Act (1934): from the reasons behind its approval to the major amendments of 1975. It also analyses the nature of Nasdaq as a self-regulatory organisation (SRO), whose marketplace rules require the SEC's approval. The court's decision analyses in detail, as the basis for its reasoning and ruling, the limits of the SEC's regulatory powers in line with the major questions doctrine, that is, the doctrine of the limits of the regulatory power of independent administrative authorities. It relates this to section 78f(b) of the Securities Exchange Act, according to which an exchange may not regulate matters not related to the purposes of the Exchange Act; therefore, the SEC should, before approving a regulatory proposal from Nasdaq, ensure that it is related to the objectives of the Securities Exchange Act of 1934, namely to protect investors and the American economy from speculative, manipulative, and fraudulent practices. In 1975, this law was also amended to remove barriers to the development of a national market system. The court recognised that the 1934 Act had other ancillary purposes, but stated that disclosure of any and all information about listed companies was not among them.

The court concludes that the SEC has not justified the diversity rule on the basis of the Securities Exchange Act (there is a dissenting opinion)

Based on a study conducted in 2020, Nasdaq concluded that it was necessary to approve rules to promote diversity on the boards of directors of companies listed on the exchange. To this end, it submitted three proposals to the SEC for approval: the 'Disclosure Rule', the 'Diversity Rule' and the 'Recruiting Rule':

- Under the first rule, the Disclosure Rule, Nasdaq-listed companies were required to provide statistical information in a uniform format on the board of directors related to a director's self-identified gender, self-identified race, and self-identification as LGBTQ+.

- The second rule, the Diversity Rule, required listed companies to have at least one director who self-identifies as a female, and (B) to have at least one director who self-identifies as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, two or more races or ethnicities, or as LGBTQ+, or (C) to explain why the company does not have at least two directors on its board who self-identify in the categories listed above. Nasdaq clarified that this rule did not establish a quota system, but rather a system of diversity objectives. As indicated, exceptions to the requirement were provided for under the comply or explain principle for foreign issuers and other entities. In the case of boards with five or fewer members, it would suffice for one director to fulfil either of the two conditions (self-identifying as either female or an underrepresented racial or sexual minority).

- As for the third rule, the Recruiting Rule, this was a free service provided by Nasdaq to assist companies in complying with the Diversity Rule.

The court states that the SEC, when approving the three regulatory proposals on diversity, argued that information about the racial, gender, and sexual characteristics of the directors of public companies was important to large institutional investors and investment managers such as Blackrock, Vanguard, State Street, Goldman Sachs or the California Public Employees' Retirement System. In the SEC's opinion, Nasdaq's proposal would make board diversity information available to these and other investors on a consistent and comparable basis. Accordingly, the supervisor reasoned that the Proposal was "designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest".

In this regard, among other considerations, the court indicates, in relation to the protection of the public interest, that this should be understood in the sense that investors or the public are protected from the kinds of harms that the Securities Exchange Act explicitly lists as its targets—that is, speculation, manipulation, fraud, anticompetitive exchange behaviour. Many exchange listing standards are related to those stated purposes. One example is the requirement for a majority-independent board. This requirement plausibly prevents fraud by ensuring that directors are insulated from officers so they can effectively guard against financial malfeasance.

In fact, the Securities Exchange Act itself imposes a board independence requirements, for example, when requiring board audit committees to be composed entirely of independent directors. This requirement was introduced by the Sarbanes-Oxley Act in 2002 following the Enron and WorldCom scandals. The stated purpose of this amendment was to protect investors by improving the accuracy and reliability of corporate disclosures.

Now the court asks itself what is the public interest that justifies the approval of the Board Diversity Proposal. Nasdaq argues that there is a link between the racial, gender, and LGTBQ+ identities of a company's board members and "the quality of a company's financial reporting, internal controls, public disclosures, and management oversight", but, in the opinion of the court, Nasdaq offers little support for its assertion. Although it proffers some studies that suggest "a positive association between gender diversity and important investor protections", the majority of judges believe that it offers only the barest speculation to support the proposition that there is any link between investor protection and racial and sexual diversity. It may be true that an exchange need not produce conclusive empirical evidence to show that a proposed rule is related to the purpose of investor protection, but the SEC cannot approve a rule simply because an exchange declared the existence of some fact. If it could, the statutory limitations on exchange authority would be dead letters. Nor does the court see a relationship between the contribution to the correct formation of prices and the Diversity Rule.

Moreover, although the obligation to provide information on diversity within the board could be justified, the Proposal also imposes an explanation requirement—it requires companies to explain why they failed to be as diverse as Nasdaq would prefer. This obligation to explain could serve the goal of investor protection only if there were some link between the reason for the lack of racial, gender, and sexual diversity on a company's board and the quality of its governance, something that Nasdaq fails to demonstrate. On the other hand, nothing

prevents listed companies from voluntarily disclosing this information.

The court is aware of the political connotations of Nasdaq's proposed rules, which, it understands, came in response to the social justice movement as an attempt to increase diversity and inclusion across public companies; but, by seeking to transform the internal structure of many of the world's largest companies, compliance with these obligations by the listed company affects the economy as a whole, so it is an issue that cannot be left in the hands of the regulatory legislator. This is an issue that divides the country; one is reminded of the *Students for Fair Admissions Inc. v. President & Fellows of Harvard Coll.* (2023) ruling regarding the discriminatory nature of the admission programmes of the universities of North Carolina and Harvard, with a dissenting vote from Judge Sotomayor ("Diversity is now a fundamental American value").

The rule of two 'diverse' directors disappears under the comply-or-explain principle

In this case too, the judgement contains a dissenting opinion, signed here by eight judges. In said opinion, the Disclosure Rule does not mean that Nasdaq evaluates the substance of a company's explanation of why it does not have two diverse board members; Nasdaq merely confirms that the explanation has been submitted. For example, a company might state that it "doesn't consider the information useful to investors" or "prioritizes diversity of thought or geography." With that, the company has complied with Nasdaq's Disclosure Rule. Nasdaq is a private company that contracts with other companies that wish to be listed on it so that, on the one hand, it facilitates the listing and trading of their securities and, on the other hand, listed companies submit to Nasdaq's rules. In accordance with the Securities Exchange Act, the SEC must approve an SRO proposal if it finds it consistent with the requirements of the 1934 law: the rules of the exchange are designed to prevent fraudulent and manipulative acts and practices, to allow for the correct formation of prices and, in general, to protect investors and the public interest. In this way, the SEC cannot displace business judgment with its own policy priorities. The role of the courts is to determine, in cases in which the SEC decides not to intervene in this private ordering—and thus to approve the SRO-proposed rule— has been arbitrary. They therefore do not agree with the description of the SEC's authority in the ruling, which extends its powers of intervention to include political motivations. They also disagree with the majority opinion when it considers that the objectives of the Securities Exchange Act do not include the mitigation of information asymmetries related to business leadership, in view of the fact that it is business leaders (board members) to whom investors entrust their money and whose identity is sought throughout the nation's economic spectrum.

In the dissenting opinion, the SEC's approval of Nasdaq's Disclosure Rule was neither arbitrary nor capricious if we place it in the context of both the information that companies have to supply to the general government and the proposed rules that the SEC has previously approved and which are consistent with the law. Thus, companies with more than one hundred employees must disclose the demographic com-

position of their workforce to the Equal Employment Opportunity Commission (EEOC). Nasdaq used these categories in the information provided by companies, to which it added LGBTQ+ identity for diversity on the boards of listed companies. Along the same lines, these companies have to inform the SEC whether the board's nominations committee considers diversity in identifying nominees for director and, if so, if they have a policy in this regard and how effective it is. In fact, if the SEC had not approved these rules, Nasdaq could have argued that the supervisor acted arbitrarily, given the limited nature of its supervisory role. In the dissenting opinion, the SEC's limited role in approving Nasdaq's rules does not permit any other conclusion, apart from the political debate on the matter.

In compliance with this ruling, not appealed to the Supreme Court, at the end of January the SEC approved Nasdaq's proposal to eliminate the 2021 board diversity rules, whereby they no longer apply to companies listed on this exchange.

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